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IN THE

Supreme Court of the United States

October Term, 1968.

No. 1162

DANICA ENTERPRISES, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

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COMMISSIONER OF INTERNAL REVENUE,

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

Taxpayer, Danica Enterprises, Inc. ("Danica") hereby petitions that a writ of certiorari issue to review the two-to-one judgment of the United States Court of Appeals for the Second Circuit, entered in the above-entitled case on December 17, 1968.

I.

OPINIONS BELOW.

The memorandum findings of fact and opinion of the Tax Court (R. 48a-57a)[1] are reported in 26 CCH TC Mem. 816 and are printed in Appendix B hereto, *infra,* pp. 19a-27a. The two-to-one opinion of the Court of Appeals, not yet reported, is printed in Appendix B hereto, *infra,* pp. 5a-18a.

II.

JURISDICTION.

The judgment of the Court of Appeals was entered on December 17, 1968, and a timely petition for rehearing was denied on January 7, 1969, Appendix B, *infra,* pp. 28a-30a. An extension of time until April 15, 1969 to file a petition for certiorari herein was granted by Mr. Justice Harlan on March 7, 1969, Appendix C, *infra,* p. 31a. The jurisdiction of this Court is invoked under 28 U. S. C. § 1254(1).

III.

STATEMENT OF QUESTION PRESENTED.

In March 1958, Victor Borge ("Borge") transferred to Danica Enterprises, Inc. ("Danica"), the taxpayer, in exchange for its stock, the assets of the rock cornish hen business which Borge had previously owned and operated as an individual. Borge had incurred losses in the hen business in excess of $50,000 in each of the preceding four years (1953-1957). In each of Danica's three subsequent fiscal years after its acquisition of the hen business from Borge (1958-1961), Danica itself sustained out-of-pocket annual operating losses in the hen business in excess of

1. As used herein, the letter "R" preceding specific pages refers to the "Appendix to Brief for Petitioners" in the Court of Appeals, a copy of which has been deposited with this Court.

$50,000 per annum. The Commissioner disallowed Danica's deductions for its 1958-61 losses in the hen business to the extent that they exceeded $50,000 per annum. He reasoned that if Borge, as an individual, had sustained in 1958 a fifth consecutive year of losses in excess of $50,000 per annum, § 270 of the Internal Revenue Code (which applies to individuals and not to corporations) would have required Borge to recompute his income tax for all five years, so as to limit his deductions for such losses to $50,000 per annum. However, rather than recomputing Borge's individual taxes under § 270 for the earlier years in which he owned the hen business, the Commissioner sought, under § 269, to deny Danica its right to deduct its own subsequent out-of-pocket operating losses incurred after it acquired the hen business from Borge. The Commissioner was upheld by the Tax Court and by a divided panel of the Court of Appeals for the Second Circuit. However, the Court of Appeals explicitly noted that its decision was in conflict with the decisions of the Court of Appeals for the Third and Sixth Circuits, which have held that post-acquisition operating losses cannot be disallowed under § 269. Therefore, the question presented is:

When persons acquire control of a corporation by transferring a business to it in exchange for stock, does § 269 authorize the Commissioner to disallow post-acquisition real out-of-pocket operating losses the corporation subsequently sustains in the business?

IV.

STATUTE INVOLVED.

The statutory provision involved is § 269 of the Internal Revenue Code of 1954, 68A Stat. 80, 26 U. S. C. § 269. The Court of Appeals also referred to § 270 thereof, 68A Stat. 81, 21 U. S. C. § 270, in its Opinion. Both sections are printed in Appendix A hereto, *infra*, pp. 1a-4a.

V.

STATEMENT OF THE CASE.

The petitioner and taxpayer is Danica Enterprises, Inc. ("Danica"), which was not formed until February 1958. The factual statement, however, must start with Victor Borge ("Borge") in 1952 since the Commissioner of Internal Revenue attributed legal significance to events which occurred before Danica in 1958 acquired the business in question from Borge.

Borge was, at all relevant times, and still is, a professional entertainer (R. 157a-159a). In addition, from April 1952 through February 28, 1958, Borge engaged as an individual proprietor in the business of processing and selling rock cornish hens under the trade name of ViBo Farms ("ViBo") (R. 49a-50a).[2] Borge was a pioneer in this business and made extensive efforts to develop it (R. 49a-50a, 139a, 143a-149a). However, he sustained losses in this business in excess of $50,000 in each of his taxable years 1954 through 1957. (Appendix B, *infra*, p. 7a). Sections 162 through 167 of the Internal Revenue Code permitted Borge to deduct in full the costs and expenses giving rise to these losses and he did so.

On March 1, 1958, Borge transferred to a new corporation, Danica, all of the assets of the hen business having a total cost of about $81,000, in exchange for all of Danica's stock and a loan payable (R. 51a, 68a, 69a; Appendix B, *infra*, p. 8a).

Borge also entered into an agreement with Danica whereby Danica would pay Borge an annual salary of $50,000 for five years and would produce certain entertainment ventures featuring Borge. Borge agreed to perform in such ventures as an employee of Danica and to appear

2. ViBo's processing operations which included killing, scalding, eviscerating and packaging, involved plant and facilities having an aggregate cost of in excess of $250,000 (R. 127a-128a, 148a).

an unlimited number of times in radio commercials sponsoring the hens sold by Danica (R. 70a-80a). Borge's entertainment services were utilized by Danica to advertise and otherwise advance the hen business (R. 109a, 110a, 150a-57a, 163a-66a).

By the time the hen business was transferred to Danica, its sales had increased, its processing and marketing had become more large scale and efficient and its losses were therefore declining (R. 49a-50a, 139a, 147a, 149a). In 1958-1959, however, after Danica's acquisition, a severe recession began in the poultry industry which lasted for several years (R. 142a-43a). Moreover, the market was flooded with a great number of inferior, cheaper birds labelled as rock cornish hens by the Department of Agriculture under an expanded definition which Danica had unsuccessfully opposed (R. 144a-45a, 176a-78a). Thus, the price for cornish hens declined drastically and Danica, based exclusively upon Danica's operation, sustained losses in the hen business as follows:

Fiscal Year Ending February 28	*Hen Business Net Income (Loss)*
1959	($309,557)
1960	(194,346)
1961	(69,473)
1962	(29,797)
	($603,173) (R. 48a-57a)

All of these losses were operating losses paid out-of-pocket by Danica in the day-to-day purchase, processing and sale of hens *after* it acquired the hen business.[3] (R. 54a, 67a, 140a-144a, 147a).

3. The total cost of the assets Danica acquired from Borge was about $81,000. Thus, even assuming that these assets were totally lost (and they were not), no less than $522,000 of Danica's hen business losses necessarily represented fresh expenditures of funds by Danica (R. 51a, 60a, 68a, 69a).

The Commissioner disallowed Danica's deductions of the hen losses in the fiscal years ending February 28, 1959 through 1961 to the extent that said losses exceeded $50,000 per annum. This ruling was upheld both by the Tax Court, whose jurisdiction was invoked by Danica's petition for redetermination of the deficiencies, and, in a two-to-one vote, by the Court of Appeals, on a petition for review of the Tax Court's decision [4] (R. 26a-33a, 48a-57a, Appendix B, *infra,* pp. 5a-27a).

The Tax Court and the Court of Appeals reasoned as follows: Since the hen business losses exceeded $50,000 in each of the four years 1953 through 1957, § 270 of the Internal Revenue Code would have been invoked if Borge had continued to conduct the business as an individual in 1958, and had sustained in that year a loss in excess of $50,000, and Borge's deductions for the 1953-1958 losses would have been disallowed to the extent they exceeded $50,000 per annum.[5] Hence, the courts concluded (and indeed Danica conceded) that Borge had transferred the hen business to Danica to avoid the recomputation and increase in

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4. The Commissioner also determined, and was sustained by the Tax Court and the Court of Appeals in determining, that there should be allocated to Borge, under § 482 of the Code, as additional compensation for his entertainment services, the excess of:

(a) the arm's length salary of $75,000 per annum which the Tax Court determined that Borge would have demanded from an unrelated party; over

(b) the amount of compensation that Danica actually paid him in the particular taxable year (R. 7a-18a, 48a-57a, Appendix B, *infra,* pp. 9a-13a).

Borge has not sought review of this ruling.

5. Section 270 provides that if, in each of five consecutive taxable years, an individual sustains a loss of an excess of $50,000 per annum in a particular business, the excess may be disallowed in each of said five years and in any subsequent consecutive taxable years in which the loss of such business exceeds $50,000. An extension of the statute of limitations is provided in order to permit the Commissioner to assert deficiencies for the earlier years (Appendix A, *infra,* pp. 3a, 4a).

his taxes that would have been required by § 270 had he continued to operate the business individually through 1958.

However, as Judge Kaufman noted in his dissent in the Court of Appeals, rather than recomputing Borge's individual tax for 1953-1957, the years prior to the transfer of the hen business to Danica, the Commissioner illogically disallowed Danica's own actual *post*-acquisition operating losses for the next three years (i.e., the fiscal years ending February 28, 1959 through 1961), to the extent that they exceeded $50,000 per annum. Thus the Commissioner and the majority in the Court of Appeals tacked on to Borge's four years of losses Danica's losses for the next three years, and then denied Danica, not Borge, its conceded deduction, even though both admitted that § 270 does not apply to corporations (Appendix B, *infra,* pp. 14a, 15a). The sole authority advanced for this ruling was § 269 of the Code, which permits the disallowance of a deduction or other benefit which has been secured by acquiring control of a corporation, where the principal purpose of the acquisition was tax evasion or avoidance (Appendix A, *infra,* pp. 1a, 2a).

The Court of Appeals explicitly stated that its disallowance of such post-acquisition operating losses of Danica under § 269 was in conflict with decisions of the Third and Sixth Circuits (Appendix B, *infra,* p. 16a). Nevertheless it affirmed, over Judge Kaufman's dissent, on the basis of what it erroneously considered to be the contrary view of the First and Seventh Circuits on the issue (Appendix B, *infra,* p. 16a).

It is on the basis of this conflict and of the importance for the proper administration of the Federal tax laws of clarifying the application of § 269 to post-acquisition operating losses, that a writ of certiorari is sought herein.

VI.

REASONS FOR GRANTING THE WRIT.

A. There Is a Conflict in the Circuits, Which the Court of Appeals Specifically Recognized, as to Whether, When a Corporation Acquires a Business in Exchange for a Controlling Interest in Its Stock, § 269 Authorizes the Commissioner to Disallow Out-of-Pocket Operating Losses the Corporation Thereafter Sustains in Its Business.

The basic issue presented in this case is whether, when a corporation acquires a business in exchange for a controlling interest in its stock, § 269 vests the Commissioner with the authority to disallow the corporation's deductions for out-of-pocket operating losses such corporation thereafter sustains in the business, based exclusively upon post-acquisition operations and events.

It was conceded by the Commissioner that §§ 162-167 of the Code permitted Danica, as a corporate taxpayer, to deduct all the costs and expenses it incurred in the hen business based upon its operations after it acquired the business from Borge. Moreover, the Commissioner also necessarily conceded that the recomputation provisions of § 270 have no applicability whatsoever to Danica, since § 270 applies only to individuals (Appendix B, *infra,* pp. 15a, 16a).

Hence, the Commissioner based his disallowance of deductions to Danica for its hen business losses exclusively upon § 269(a) which, in relevant part, provides that:

> If—
>
> (1) any person or persons acquire . . ., directly or indirectly, control of a corporation, . . . and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by *securing the benefit of a*

> *deduction, credit or other allowance which such person or corporation would not otherwise enjoy,* then the Secretary or his delegate may disallow such deduction, credit, or other allowance. (Italics supplied.)

Traditionally, § 269 has been utilized to prohibit a corporation from carrying over net operating losses previously reported by another business which the taxpayer corporation acquired in exchange for a controlling interest in its stock. (See, BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, §§ 13.20-21, at 629, 630, 632 (2d ed. 1966)). In the last few years, however, the Commissioner has taken the position that § 269 is broad enough to prohibit the taxpayer corporation not only from carrying over pre-existing net operating losses of the acquired business ("pre-acquisition losses"), but also to bar the taxpayer corporation from deducting losses it incurs in its own operation of the acquired business after the acquisition ("post-acquisition losses").

To date, five Federal Courts of Appeals have considered this important and recurring issue and have evolved at least three distinct positions on the status of such post-acquisition losses under § 269:

1. *The Third and Sixth Circuits.*

The Courts of Appeals for the Third and Sixth Circuits have squarely held that post-acquisition losses may not be disallowed under § 269 when they are actual out-of-pocket operating losses. *Zanesville Investment Co. v. Commissioner,* 335 F. 2d 507 (6th Cir. 1964); *Herculite Protective Fabrics Corp. v. Commissioner,* 387 F. 2d 475 (3d Cir. 1968).[6] These cases explicitly hold that "post-

6. The *Zanesville* case went on to hold that Section 269 might be applied to a post-acquisition loss which was not of an operating and out-of-pocket nature, i.e., a loss which was already "built-in"

affiliation operating losses standing by themselves are not within the coverage of Section 269." *Zanesville Investment Co. v. Commissioner, supra* at p. 511. In fact the *Zanesville* opinion at 335 F. 2d at p. 514, explicitly stated that § 269 could not be utilized to disallow such losses even when they were "anticipated" at the time of the acquisition.[7]

These Circuits ruled that § 269 is limited to situations in which the taxpayer corporation is attempting to "distort" its income, and realize an undeserved "benefit," by utilizing a loss realized in an economic sense before it owned the business in question. Under this view clearly, there is no "distortion" or "benefit" in permitting a corporation to deduct an out-of-pocket loss it sustained from its own funds after it acquires a business.

2. *The First and Seventh Circuits.*

By contrast, the Courts of Appeal for the First and Seventh Circuits have held that post-acquisition operating losses may be disallowed under Section 269, but only when:

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to the assets of the business when the corporation acquired it, although not yet recognized for tax purposes. A good example of a built-in loss is that involved in the *Zanesville* case, namely, a loss resulting from the sale by the acquiring corporation of fixed assets which had already declined in value at the time of the acquisition (see also the definition of a "built-in" loss in Treas. Reg. 1.1502-15(a)(2) (1966), discussed at p. 15, *infra*).

The Commissioner did not contend in this case that Danica's hen business losses were "built-in" to the assets it acquired from Borge. Rather, it argued the case on the contrary premise. Indeed, as noted above, the total cost of the assets Danica acquired from Borge was only $81,000 as against its total hen business losses of $603,000. The difference of $522,000 in the loss was necessarily funded by Danica's out-of-pocket operating expenditures.

7. This was also the position of Judge, now Chief Judge, Aldrich of the First Circuit, dissenting in *R. P. Collins & Co. v. United States*, 303 F. 2d 142, 147 (1st Cir. 1962).

(a) the acquiring corporation also deducts far more substantial pre-acquisition losses (as net operating loss carryovers);[8] *and*

(b) it was necessary in view of other provisions of the Code, for the acquiring corporation to continue the business (and, therefore, incur the post-acquisition operating losses) in order to obtain the benefit of the far more substantial pre-acquisition losses.[9]

R. P. Collins & Co. v. United States, 303 F. 2d 142 (1st Cir. 1962); *Luke v. Commissioner*, 351 F. 2d 568 (7th Cir. 1965).

In view of the hoped-for preservation of the substantial pre-acquisition losses sought to be deducted in *Collins* and *Luke*, there was a "benefit" to the acquiring corporation, and its shareholders, in incurring the post-acquisition losses in these circumstances. In the words of the majority opinion in *Collins*, the post-acquisition losses were "tarred with the same brush" which disallowed the pre-acquisition losses. 303 F. 2d at 146.[10]

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8. In *Luke v. Commissioner*, 351 F. 2d 568 (7th Cir. 1965), the pre-acquisition losses were $390,000, whereas the post-acquisition losses were only $97,000. Similarly, in *R. P. Collins & Co. v. United States*, 303 F. 2d 142 (1st Cir. 1962), the primary benefits sought to be achieved were $223,000 in pre-acquisition net operating loss carryovers and a $150,000 "built-in loss" on the sale of certain fixed assets which had already declined in value. The $19,000 subsequent operating loss was incurred merely as an incident of continuing the business for long enough to sell the fixed assets.

9. For example, Section 382, which was involved in *Luke*, provides that when a 50% or greater change in the stock ownership in the corporation takes place, pre-existing net operating losses can be carried over only if the business which sustained the losses is continued. This is why it was necessary to continue the acquired business in *Collins* and in *Luke* (thereby sustaining the post-acquisition losses) in order to achieve deductions for the far more substantial pre-acquisition net operating losses.

10. It should be noted that the Third Circuit in the *Herculite* case, *supra*, refused to disallow a post-acquisition loss of $11,000 even in the face of the carryover of pre-acquisition losses of $77,000. See also *R. P. Collins & Co. v. United States*, 303 F. 2d 142, 147 (1st Cir. 1962) (Aldrich, J. dissenting).

3. *The Second Circuit.*

Finally, the Court of Appeals for the Second Circuit ruled, in the present case, that post-acquisition losses may be disallowed under Section 269, even when they are out-of-pocket operating losses (i.e., not "built-in" losses: "built-in" losses are "losses which had economically accrued prior to the [acquisition] but which had not as yet been realized in a tax sense." *Zanesville* at p. 508), and even when they were not incurred in order to maintain carry-over deductions for any pre-acquisition losses.

The Second Circuit's opinion explicitly notes that its ruling conflicts with the decisions of the Third and Sixth Circuit Courts of Appeals (Appendix B, *infra*, p. 16a). In fact, as shown above, the Second Circuit's decision actually conflicts with the decisions of the First and Seventh Circuit Courts as well. Thus, this case represents the first in which post-acquisition operating losses were disallowed in the complete absence of any pre-acquisition loss carry-overs. Nevertheless, the Court of Appeals for the Second Circuit rejected the taxpayer's claim simply stating:

> "While there is authority to the contrary (*Herculite Protective Fabrics Corp. v. Commissioner*, 387 F. 2d 475 (3d Cir. 1968); *Zanesville Inv. Co. v. Commissioner*, 335 F. 2d 507 (6th Cir. 1964)), the better view permits the disallowance of deductions for post-acquisition losses of an acquired corporation where those deductions were a part of the purpose for which the corporation was acquired. *Luke v. Commissioner*, 351 F. 2d 568 (7th Cir. 1965); *R. P. Collins & Co. v. United States*, 303 F. 2d 142 (1st Cir. 1962). See also, *J. T. Slocomb Co. v. Commissioner*, 334 F. 2d 269 (2d Cir. 1964)." (Appendix B, *infra*, p. 16a).

B. The Issue Is of Great Public Importance and Is of Far-reaching Significance.

The importance for the proper administration of the Federal tax laws of authoritatively determining whether, or under what circumstances, § 269 may be utilized to disallow out-of-pocket operating losses realized by a taxpayer corporation in an acquired business is graphically demonstrated by the fact that in the past six years five Federal Courts of Appeals have been called upon to decide the question and have reached three different answers, and also by the spate of legal commentary those decisions have evoked.[11]

In addition, resolution of the problem by this Court would go far to determine the proper role of § 269 in the Federal tax laws. Although § 269 is merely one of several statutory and judicial devices for preventing tax avoidance, the Commissioner had increasingly in the past few years put aside the use of the more settled provisions to utilize the vague and general terms of § 269. Thus, the records of the Internal Revenue Service disclose 53 reported decisions under § 269 in the past five years, and more than 500 cases pending in which it is involved. *Internal Revenue Service, General Counsel's List of Pending Cases* (October 25, 1968).

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11. E.g., Comment, *Section 269 of the Internal Revenue Code and the Status of Postacquisition Losses*, 33 U. Chi. L. Rev. 577 (1966); Adlman, *Recent Cases Increasingly Extend Section 269 to Disallow Post-Acquisition Operating Losses*, 17 J. Taxation 282 (1962); Bean, *Section 269 and Postacquisition Losses*, 49 A. B. A. J. 907 (1963); Dominianni, *Zanesville Decision Places Much-Needed Brake on IRS' Misapplication of Section 269*, 22 J. Taxation 88 (1965); Dunn, *The New Consolidated Return Regulations May Preempt the Field in Determining the Allowance of Operation Losses*, 23 Tax L. Rev. 185, 201-09 (1968); Hagendorf, *Zanesville Allows Tax Avoidance Through Use of Post-acquisition Operating Losses*, 21 J. Taxation 262 (1964); *Loss Carryovers*, 21 The Tax Lawyer 790, 792-93 (1968).

C. The Decisions of the Court of Appeals for the Sixth and Third Circuits Are Correct and the Decision of the Second Circuit in This Case Is in Error.

The decision of the Second Circuit in this case completely disregards the legislative intent in enacting § 269. The Senate report regarding the Section stated:

> "The objective of the section, as stated in the report of the House bill, is to prevent the distortion through tax avoidance of the deduction, credit, or allowance provisions of the Code . . . The House report also recognizes that the legal effect of the section is . . . to codify . . . the general principle . . . as to the ineffectiveness of arrangements *distorting or perverting deductions . . . . so that they no longer bear a reasonable business relationship to the interests or enterprises which produced them* and for the benefit of which they were provided." (Italics supplied.) S. Rep. No. 627, 78th Cong., 1st Sess. 58 (1943). See also H. R. Rep. No. 871, 75th Cong., 1st Sess. 49 (1943) ("reduction through artifice"); Testimony of Randolph Paul, General Counsel, Hearings Before the Senate Committee on Finance on the Revenue Act of 1943, 78th Cong., 1st Sess. 45 (1943).

As recognized by all the Circuits, a "distortion" may result if a corporation is permitted to carry over a loss sustained in a business *before* the corporation acquired the business. Likewise, as recognized by the Third and Sixth Circuits, a "distortion" may result if a corporation is permitted to deduct a loss which is already "built-in" to the assets of a business when it acquired it, although it is not yet realized for tax purposes. However, as the Third and Sixth Circuits have held, there can scarcely be any "distortion" in permitting a corporation to deduct an operating loss it incurs, out-of-pocket, with its own funds.

The specific statutory support for the Third and Sixth Circuit decisions denying the applicability of Section 269 to post-acquisition operating losses is that the Section by its terms applies solely to disallow deductions of which the acquiring shareholders could not have otherwise "enjoyed the benefit." As decided by the First and Seventh Circuits in *Collins* and *Luke*, there may be such a "benefit" in post-acquisition operating losses when they are incurred in order to preserve the carryover of far larger pre-acquisition losses which were not really incurred by the acquiring corporation. However, in the case of a post-acquisition, out-of-pocket operating loss, *standing by itself*, as in this case, no "benefit" exists at all, since the taxpayer has made an out-of-pocket expenditure of $1 and received a tax saving of only 52¢.

Indeed, the propriety of limiting § 269 to only such post-acquisition losses as are "built-in" has been recognized by the Service's own regulations. In both the *Collins* and *Zanesville* cases, the acquiring corporation deducted the post-acquisition losses on a consolidated return. Yet, after both these decisions were rendered, the Service issued new consolidated return regulations which, in so many words, adopted the "built-in" loss standard of *Zanesville*. These regulations bar a parent from utilizing post-acquisition losses of a newly acquired subsidiary only when said losses are "built-in" at the time of the acquisition Treas. Reg. § 1.1502-15(a)(2)(1966). Thus, it is highly inconsistent for the Service now to urge the application of § 269 to post-acquisition operating losses which are not of a "built-in" character. *Zanesville Investment Co. v. Commissioner*, *supra*, at p. 510, see Dunn, *The New Consolidated Return Regulations May Preempt the Field in Determining the Allowance of Operating Losses*, 23 Tax L. Rev. 185, 201-09 (1968).

CONCLUSION.

For the reasons given above, it is respectfully submitted that this Court should grant the petition for a writ of certiorari to review the judgment of the Court of Appeals for the Second Circuit.

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Dated: March 14, 1969

APPENDIX A.

Internal Revenue Code of 1954.

§ 269. Acquisitions made to evade or avoid income tax.

(a) In general.—If

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary or his delegate may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

(b) Power of Secretary or his delegate to allow deduction, etc., in part.—In any case to which subsection (a) applies the Secretary or his delegate is authorized—

(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection,

if he determines that such allowance will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(2) to distribute, apportion, or allocate gross income, and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income tax for which the acquisition was made; or

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2).

(c) Presumption in case of disproportionate purchase price.—The fact that the consideration paid upon an acquisition by any person or corporation described in subsection (a) is substantially disproportionate to the aggregate—

(1) of the adjusted basis of the property of the corporation (to the extent attributable to the interest acquired specified in paragraph (1) of subsection (a)), or of the property acquired specified in paragraph (2) of subsection (a); and

(2) of the tax benefits (to the extent not reflected in the adjusted basis of the property) not available to such person or corporation otherwise than as a result of such acquisition,

shall be prima facie evidence of the principal purpose of evasion or avoidance of Federal income tax. This subsection shall apply only with respect to acquisitions after

March 1, 1954. Aug. 16, 1954, c. 736, 68A Stat. 80; Feb. 26, 1964, Pub. L. 88-272, Title II, § 235(c)(2), 78 Stat. 126.

§ 270. Limitation on deductions allowable to individuals in certain cases.

(a) Recomputation of taxable income.—If the deductions allowed by this chapter or the corresponding provisions of prior revenue laws (other than specially treated deductions, as defined in subsection (b)) allowable to an individual (except for the provisions of this section or the corresponding provisions of prior revenue laws) and attributable to a trade or business carried on by him for 5 consecutive taxable years have, in each of such years (including at least one year to which this subtitle applies), exceeded by more than $50,000 the gross income derived from such trade or business, the taxable income (computed under section 63 or the corresponding provisions of prior revenue laws) of such individual for each of such years shall be recomputed. For the purpose of such recomputation in the case of any such taxable year, such deductions shall be allowed only to the extent of $50,000 plus the gross income attributable to such trade or business, except that the net operating loss deduction, to the extent attributable to such trade or business, shall not be allowed.

(b) Specially treated deductions.—For the purpose of subsection (a) the specially treated deductions shall be taxes, interest, casualty and abandonment losses connected with a trade or business deductible under section 165(c)(1), losses and expenses of the trade or business of farming which are directly attributable to drought, the net operating loss deduction allowed by section 172, and expenditures as to which taxpayers are given the option, under law or regulations, either (1) to deduct as expenses when incurred or (2) to defer or capitalize.

(c) Redetermination of tax. On the basis of the taxable income computed under the provisions of subsection (a) for each of the 5 consecutive taxable years specified in such subsection, the tax imposed by this subtitle or the corresponding provisions of prior revenue laws shall be redetermined for each such taxable year. If for any such taxable year assessment of a deficiency is prevented (except for the provisions of section 1311 and following) by the operation of any law or rule of law (other than Section 7122, relating to compromises), any increase in the tax previously determined for such taxable year shall be considered a deficiency for purposes of this section. For purposes of this section, the term "tax previously determined" shall have the meaning assigned to such term by section 1314(a)(1).

(d) Extension of statute of limitations—Notwithstanding any law or rule of law (other than section 7122, relating to compromises), any amount determined as a deficiency under subsection (c), or which would be so determined if assessment were prevented in the manner described in subsection (c), with respect to any taxable year may be assessed as if on the date of the expiration of the time prescribed by law for the assessment of a deficiency for the fifth taxable year of the 5 consecutive taxable years specified in subsection (a), 1 year remained before the expiration of the period of limitation upon assessment for any such taxable year. Aug. 16, 1954, c. 736, 68A Stat. 81.

APPENDIX B.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 15 and 16—September Term, 1968.

(Argued September 30, 1968 Decided December 17, 1968.)

Docket Nos. 31903, 31904

VICTOR BORGE, SANNA BORGE, and
DANICA ENTERPRISES, INC.,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Before:

SMITH, KAUFMAN and HAYS,

Circuit Judges.

Petition for review of a decision of the Tax Court, J. E. Murdock, *Judge*, sustaining the Commission's determination of deficiencies in taxpayers' income tax payments for the years 1958 through 1962, inclusive. The Tax Court held (1) that the Commissioner, acting under Section 482 of the Internal Revenue Code of 1954, 26 U. S. C. § 482 (1964), properly allocated to Borge a portion of the compensation paid to Borge's wholly owned corporation for services performed by him, and (2) that the Commissioner, acting under Section 269 of the Internal Revenue Code of

1954, 26 U. S. C. § 269 (1964), properly denied as deductions the corporation's losses in excess of $50,000 per year and its loss carry-overs.

Affirmed as modified and remanded for recomputation of the deficiency.

MILTON YOUNG, New York, N. Y. (Stephen S. Ziegler and Robert D. Howard, on the brief), *for Petitioners.*

LOUIS M. KAUDER, Attorney, Department of Justice (Mitchell Rogovin, Assistant Attorney General and Lee A. Jackson and Harry Baum, Attorneys, Department of Justice, on the brief), *for Respondent.*

HAYS, *Circuit Judge:*

Petitioners seek review of a decision of the Tax Court sustaining the Commissioner's determination of deficiencies in their income tax payments for the years 1958 through 1962, inclusive. The Tax Court upheld both the Commissioner's allocation to Borge [1] under Section 482 of the Internal Revenue Code of 1954, 26 U. S. C. § 482 (1964), of a portion of the compensation received by Danica Enterprises, Inc., Borge's wholly owned corporation, for services performed by Borge as an entertainer, and the Commissioner's disallowance, under Section 269 of the Internal Revenue Code of 1954, 26 U. S. C. § 269 (1964), of Danica's deduction of losses from its rock cornish hen business in

1. "Borge" refers herein to Victor Borge. His wife has been included as a party to the action solely because of the filing of joint returns.

2. The Commissioner has filed a protective petition for review to assure that Danica will not be permitted to deduct the compensation allocated to Borge if the decision of the Tax Court is reversed.

excess of $50,000 per year, and of its loss carryovers.[2] We affirm.

From April 1952 through February 28, 1959, Borge conducted a poultry business on a 400-acre farm in Connecticut under the name of ViBo Farms. The farm business centered on and pioneered in the development and commercial sale of processed, quality chickens called rock cornish hens.

Borge incurred substantial losses in his poultry business.[3] For each of the years 1954 through 1957 the poultry losses exceeded $50,000. In the first two months of 1958 the poultry losses amounted to $23,133, and market conditions were unfavorable. Borge's tax consultant advised him that if the poultry losses for 1958 exceeded $50,000 the Commissioner would probably recompute Borge's taxes for each year that the losses had exceeded $50,000, pursuant to Section 270 of the Internal Revenue Code of 1954, 26 U. S. C. § 270 (1964).[4] In an effort to avoid the applica-

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3. Borge's net losses from the poultry business were as follows:

Calendar Year	*Net Loss*
1953	$ 26,665
1954	62,159
1955	79,486
1956	345,879
1957	220,146
1958 (through February 28)	23,133

4. § 270. Limitation on deductions allowable to individuals in certain cases.

(a) Recomputation of taxable income.

If the deductions allowed by this chapter . . . and attributable to a trade or business carried on by him for 5 consecutive taxable years have, in each of such years . . ., exceeded by more than $50,000 the gross income derived from such trade or business, the taxable income . . . of such individual for each of such years shall be recomputed. For the purpose of such recomputation in the case of any such taxable year, such deductions shall be allowed only to the extent of $50,000 plus the gross income attributable to such trade or business, except that the net operating loss deduction, to the extent attributable to such trade or business, shall not be allowed.

tion of Section 270, Borge organized Danica and, on March 1, 1958, transferred to the corporation, in exchange for all of its stock and a loan payable, the assets of the poultry business (except the farm real property).

Borge is a well-known professional entertainer. During the years preceding the organization of Danica he made large sums from television, stage and motion picture engagements.

Since Danica had no means of meeting the expected losses from the poultry business, Borge and Danica entered into a contract at the time of the organization of the corporation under which Borge agreed to perform entertainment and promotional services for the corporation for a 5-year period for compensation from Danica of $50,000 per year. Danica offset the poultry losses [5] against the entertainment profits, which far exceeded the $50,000 per year it had contracted to pay Borge.[6] Borge obviously would not have entered into such a contract with an unrelated party.

Danica did nothing to aid Borge in his entertainment business. Those who contracted with Danica for Borge's

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5. Danica's net poultry losses for the tax years here in dispute were as follows:

Fiscal Year (ending February 28)	*Net Loss*
1959	$309,557
1960	194,346
1961	69,473
1962	29,797
1963	57,586

6. Danica's net entertainment income for the years in dispute, before deducting Borge's salary, averaged $166,465. The annual net entertainment income was as follows:

Fiscal Year (ending February 28)	*Net Entertainment Income*
1959	$141,441
1960	146,402
1961	143,826
1962	283,315
1963	117,340

entertainment services required Borge personally to guarantee the contracts. Danica's entertainment earnings were attributable solely to the services of Borge, and Danica's only profits were from the entertainment business.

The only year during the period in dispute in which Danica actually paid Borge anything for his services was 1962, when Borge was paid the full $50,000.

The issues in controversy are (1) whether the Commissioner, acting under Section 482 of the Internal Revenue Code of 1954, 26 U. S. C. § 482 (1964), properly allocated to Borge from Danica $75,000 per year from 1958 through 1961 and $25,000 for 1962, and (2) whether the Commissioner, acting under Section 269 of the Internal Revenue Code of 1954, 26 U. S. C. § 269 (1964), properly disallowed Danica's loss deductions in excess of $50,000 per year for fiscal years 1959 through 1961 and of its net loss carryovers for fiscal years 1960 through 1962.

I.

When two or more organizations, trades or businesses, whether or not incorporated, are owned or controlled by the same interests, Section 482 of the Internal Revenue Code of 1954, 26 U. S. C. § 482 (1964), authorizes the Commissioner to apportion gross income between or among such organizations, trades or businesses if he deems that apportionment is necessary clearly to reflect income or to prevent evasion of tax.[7] We conclude that the Commis-

7. § 482. Allocation of income and deductions among taxpayers.
In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

sioner could properly have found that for purposes of Section 482 Borge owned or controlled two businesses, an entertainment business and a poultry business, and that the allocation to Borge of part of the entertainment compensation paid to the corporation was not error.[8]

We accept, as supported by the record, the Tax Court's finding: that Borge operated an entertainment business and merely assigned to Danica a portion of his income from that business; that Danica did nothing to earn or to assist in the earning of the entertainment income; that Borge would not have contracted for $50,000 per year with an unrelated party to perform the services referred to in his contract with Danica. Thus Borge was correctly held to be in the entertainment business.

At the same time Danica, Borge's wholly owned corporation, was in the poultry business.

Petitioners, relying primarily on *Whipple v. Commissioner,* 373 U. S. 193 (1963), argue that Borge is not an "organization, trade or business" and that Section 482 is therefore inapposite.

In *Whipple* the Supreme Court held only that where one renders services to a corporation as an investment, he is not engaging in a trade or business:

> "Devoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished

8. We agree with petitioners' contention that since Borge's employment contract with Danica went into effect on March 1, 1958, the 1958 allocation should have been only $62,500 (5/6 of $75,000). A recomputation of Borge's deficiency to this extent should be made.

> from the trade or business of the taxpayer himself. When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer, though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation." 373 U. S. at 202.

Here, however, Borge was in the business of entertaining. He was not devoting his time and energies to the corporation; he was carrying on his career as an entertainer, and merely channeling a part of his entertainment income through the corporation.

Moreover, in *Whipple* petitioner was devoting his time and energies to a corporation in the hope of realizing capital gains treatment from the sale of appreciated stock. When the hoped-for appreciation did not materialize he attempted to deduct his losses as ordinary losses. The Court decided that where one stands to achieve capital gains through an investment, any losses incurred in connection with the investment are capital losses. Borge is clearly earning ordinary income; the only question is who should pay the taxes on it. Thus, *Whipple* is not apposite.

For somewhat similar reasons we find *Commissioner v. Gross,* 236 F. 2d 612 (2d Cir. 1956), on which petitioner also seeks to rely, also inapposite.

Nor do we consider the other cases cited by petitioners persuasive. The Commissioner is not arguing here, as he did, for example, in *Charles Laughton,* 40 B. T. A. 101 (1939), remanded, 113 F. 2d 103 (9th Cir. 1940), that the taxpayer should be taxed on the entire amount paid into the wholly owned corporation, i.e. that the corporation should be ignored. See also *Pat O'Brien,* 25 T. C. 376 (1955); *Fontaine Fox,* 37 B. T. A. 271 (1938). Instead he recognizes the existence of the corporation, but under

Section 482 allocates a portion of its income to its sole shareholder who alone was responsible for the production of such income.

Petitioner contends that the Congress, in enacting the personal holding company and collapsible corporation provisions of the Code, precluded the Commissioner's action in this case under Section 482. We do not read those provisions, however, as the only available methods for dealing with the situations there involved. As the Third Circuit said in *National Sec. Corp. v. Commissioner,* 137 F. 2d 600, 602 (3d Cir.), cert. denied, 320 U. S. 794 (1943),

> "In every case in which [Section 482] is applied its application will necessarily result in an apparent conflict with the literal requirements of some other provision of the [Internal Revenue Code]. If this were not so Section [482] would be wholly superfluous."

The fact that similar, but not identical, factual situations have been dealt with by legislation does not mean that this situation, because it was not also specifically dealt with by legislation, cannot be reached even by a general code provision.

We thus conclude that the Tax Court was correct in upholding the Commissioner's ruling that Borge controlled two separate businesses. See *Pauline W. Ach,* 42 T. C. 114 (1964), aff'd, 358 F. 2d 342 (6th Cir.), cert. denied, 385 U. S. 899 (1966).

The Commissioner's action in allocating a part of Danica's income to Borge was based upon his conclusion that such allocation was necessary in order clearly to reflect the income of the two businesses under Borge's common control. The Commissioner's allocation has received the approval of the Tax Court. As this Court held in dealing with the predecessor of Section 482, "Whether the Tax Court was correct in allocating income to the petitioner

under § 45 [of the Internal Revenue Code of 1939] is essentially one of fact and the decision below must be affirmed if supported by substantial evidence." *Advance Mach. Exch. v. Commissioner,* 196 F. 2d 1006, 1007-08 (2d Cir.), cert. denied, 344 U. S. 835 (1952). See Int. Rev. Code of 1954, § 7482(a), 26 U. S. C. § 7482(a) (1964). Here the determination of the Commissioner and the decision of the Tax Court are supported by substantial evidence that the income of Borge's two businesses has been distorted through Borge's having arranged for Danica to receive a large part of his entertainment income although Danica did nothing to earn that income, and the sole purpose of the arrangement was to permit Danica to offset losses from the poultry business with income from the entertainment business. The amount allocated by the Commissioner ($75,000 per year) was entirely reasonable—indeed, generous—in view of the fact that Danica's annual net income from Borge's entertainment services averaged $166,465 during the years in question.

II.

Section 269 of the Internal Revenue Code of 1954, 26 U. S. C. § 269 (1964), provides that where any person acquires control of a corporation for the principal purpose of evading or avoiding federal income taxes by securing the benefit of a deduction or other allowance not otherwise available, the Commissioner may disallow the deduction or allowance.[9]

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9. § 269. Acquisitions made to evade or avoid income tax.
(a) In general.
If—

> (1) any person or persons acquire . . ., directly or indirectly, control of a corporation, . . .

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary or his delegate may disallow such deduction, credit, or other allowance.

As we have pointed out above Borge organized Danica in order to avoid the recomputation of taxes authorized by Section 270 of the Internal Revenue Code of 1954, 26 U. S. C. § 270 (1964).[10] The Tax Court found that "the Commissioner had reason to hold that 'the principal purpose for which [Borge acquired control of Danica]' was evasion of Federal income tax within the meaning of section 269 . . . ." That finding is not clearly erroneous and must, therefore, be accepted. *Whipple v. Commissioner, supra,* 373 at 203-04; *Commissioner v. Duberstein,* 363 U. S. 278, 289-91 (1960); *J. T. Slocomb Co. v. Commissioner,* 334 F. 2d 269, 273 (2d Cir. 1964); *Advance Mach. Exch. v. Commissioner, supra,* 196 F. 2d at 1007-08. Indeed, petitioners do not challenge the finding.

Since Borge's purpose in organizing Danica was avoidance of the $50,000 per year loss limitation of Section 270, the Commissioner did not act unreasonably in disallowing, under Section 269, deductions for subsequent years in excess of $50,000—deductions which Borge would have been denied if Danica had not been organized.

We find no merit in petitioner's contention that, because Section 270 applies only to deductions "allowable to an individual," Section 269 cannot be used to disallow a deduction claimed by Danica. Section 269 is a general provision. It was "designed to put an end promptly to any market for, or dealings in, interests in corporations or property which have as their objective the reduction through artifice of the income or excess profits tax liability." H. R. Rep. No. 871, 78th Cong., 1st Sess. (1943), reprinted in 1944 Cum. Bull. 901, 938. As the Congress recognized,

> "[T]he devices [by which taxes are avoided] take many forms. Thus, the acquisition may be an acquisition of the shares of a corporation, or it may be an acquisition which follows by operation of law in the case of a cor-

10. See note 4 *supra.*

poration resulting from a statutory merger or consolidation. The person, or persons, making the acquisition likewise vary, as do the forms or methods of utilization under which tax avoidance is sought. Likewise, the tax benefits sought may be one or more of several deductions or credits, including the utilization of excess profits credits, carry-overs and carry-backs of losses or unused excess profits credits, and anticipated expense of other deductions. In the light of these considerations, the section has not confined itself to a description of any particular methods for carrying out such tax avoidance schemes but has included within its scope these devices in whatever form they may appear." *Id.;* accord, S. Rep. No. 627, 78th Cong., 1st Sess. (1943), reprinted in 1944 Cum. Bull. 973, 1016-17.

It would subvert the purposes of Section 269 to deny the Commissioner the power to disallow the deductions here.

It is argued that Danica's deductions should be allowed because Section 270 does not limit a corporation's deductions to $50,000 regardless of how many years it loses more than that amount. The fact that Danica might have been allowed an unlimited loss deduction had it run the poultry business from its inception in no way tends to contradict the finding that Danica was incorporated with the purpose of evading or avoiding federal income taxes. There is no reason for giving taxpayers the benefit of an incorporation which they did not themselves undertake.

Petitioner also argues that Section 269 may not be used to disallow any but built-in losses of the corporation. Nothing in the language of the statute suggests any such limitation on the deductions that may be disallowed. The only requirement is that the deduction be one that the taxpayer would not enjoy but for incorporation. Both the House and the Senate reports specifically state that "anticipated" or

"prospective" losses were among those that the Commissioner could disallow as deductions under Section 269. H. R. Rep. No. 871, 78th Cong., 1st Sess. (1943), reprinted in 1944 Cum. Bull. 901, 938; S. Rep. No. 627, 78th Cong., 1st Sess. (1943), reprinted in 1944 Cum. Bull. 973, 1016. While there is authority to the contrary (*Herculite Protective Fabrics Corp. v. Commissioner,* 387 F. 2d 475 (3d Cir., 1968); *Zanesville Inv. Co. v. Commissioner,* 335 F. 2d 507 (6th Cir. 1964)) the better view permits the disallowance of deductions for post-acquisition losses of an acquired corporation where those deductions were a part of the purpose for which the corporation was acquired. *Luke v. Commissioner,* 351 F. 2d 568 (7th Cir. 1965); *R. P. Collins & Co. v. United States,* 303 F. 2d 142 (1st Cir. 1962). See also *J. T. Slocomb Co. v. Commissioner,* 334 F. 2d 269 (2d Cir. 1964).

Petitioners' final argument is that there could have been no attempt to avoid or evade the application of Section 270 because there were no five consecutive years in which the poultry business' deductions exceeded its gross income by $50,000. It is sufficient to dispose of that contention to note that the parties stipulated to the contrary.

Affirmed as modified and remanded for recomputation of the deficiency.

KAUFMAN, *Circuit Judge* (dissenting in part):

I dissent from that portion of the majority opinion affirming the Tax Court's denial to Danica of deductions for business losses in excess of $50,000 under §§ 269 and 270.

I do not dispute the correctness of the Tax Court's findings that Borge, as the sole proprietor of the ViBo business, had sustained losses in excess of $50,000 in each of the years 1954-1957, and that he incorporated the business for

the purpose of avoiding a recomputation of his income disallowing loss deduction in excess of $50,000, which § 270 would have called into play had he sustained another such loss in 1958. Nevertheless, I believe the application of § 270 to Danica through § 269 is improper in this case.

The purpose of § 270 is to limit the extent to which the government will participate in the losses sustained by an individual in the conduct of his trade or business—participation which may be greater than in the case of corporate losses because individual tax rates are higher than corporate rates. It is perfectly clear that § 270, of its own force, has no application to corporate loss deductions and places no limit on the amount of such deductions which a corporation may claim. Thus if the ViBo business had been incorporated from its inception, § 270 would have been of no relevance to it. A problem midway between initial incorporation and the instant case would arise if, for instance, ViBo, while operated as an individual proprietorship, had sustained losses in excess of $50,000 for at least five consecutive years, and after Borge had been disallowed deductions in excess of $50,000 for those years, he had then incorporated the enterprise, which continued to suffer such losses. In such an instance, even if the incorporation was for the purpose of avoiding further disallowance of loss deductions under § 270, the corporation thenceforth should be permitted to deduct the full amount of its losses otherwise allowable. Since the enterprise has already been disallowed any benefit it might have obtained from its prior operation as an individual proprietorship (i.e., the deduction of losses at the higher individual tax rate), there appears no good reason why it should not now be afforded the same treatment as an enterprise incorporated *ab initio*. From this it follows that where, as here, the business is incorporated just before § 270 would be called into play for the purpose of avoiding its application, the proper remedy

under § 269 is to disallow the benefit actually obtained by the enterprise while operated as an individual proprietorship. And that benefit was the deduction of business losses from individual income. Thus, the Commissioner should have recomputed the loss deductions for the years ViBo was unincorporated; the remedy which he chose instead, and of which the majority approves, bears no necessary correlation to the deduction benefit which Borge obtained by incorporating ViBo in avoidance of § 270.

Since the Commissioner did not thus seek to recompute Borge's income, but only that of Danica, I would reverse on this issue.

Victor Borge and Sanna Borge

v.

Commissioner.

Danica Enterprises, Inc.

v.

Commissioner.

Docket Nos. 6328-65, 6329-65.

T. C. Memo. 1967-173. Filed August 24, 1967.

MEMORANDUM FINDINGS OF FACT AND OPINION

The Commissioner determined deficiencies in income tax against the Borges and Danica as follows:

Year	Borges	Danica
1958	$75,667.51	.....
1959	62,983.39	$ 4,932.27
1960	58,178.00	1,847.21
1961	56,892.00	5,632.80
1962	22,927.00	60,713.00

The issue for decision in the Borge cases is whether the Commissioner erred in allocating and taxing to Victor in each of the first four tax years, under sections 61 and 482 of the Internal Revenue Code of 1954, $75,000 and, in 1962, $25,000 of income received by Danica Enterprises, Inc. and never transferred to Victor.

The issue for decision in the Danica Enterprises, Inc. cases is whether the Commissioner erred in disallowing a deduction in each of its first three fiscal years ended Febru-

ary 28 or 29, 1959, 1960 and 1961 for that portion of its net loss in excess of $50,000 in operating its poultry business, and is disallowing net loss carry-overs from its fiscal years (1) 1959 to 1960 (2) 1959 and 1960 to 1961, and (3) 1959 and 1960 to 1962 under section 269 of the Internal Revenue Code of 1954.

FINDINGS OF FACT.

The Borges are husband and wife who resided during the tax years in Connecticut and filed joint returns for 1958 and 1959 with the director of internal revenue for the district of New York, New York, and for 1960, 1961 and 1962 with the director of internal revenue for the district of Newark, New Jersey. They have five childern.

Danica Enterprises, Inc. is a Connecticut corporation which had its principal office during the tax years at Newark, New Jersey and filed its returns for its fiscal years director of internal revenue for the district of New York, New York, and its returns for its fiscal years ended February 28, 1961 and 1962 with the director of internal revenue for the district of Newark, New Jersey.

Victor is and was during the tax years a well-known and very successful professional entertainer. He had large income from that profession at all times material hereto. He purchased a farm property of about 400 acres at 4 Poverty Road, Southbury, Connecticut in April 1952 and resided in the main building there with his wife and children from 1952 at least through the tax years. He sold some pheasants and ducks raised on the farm and first learned of the rock cornish hen from the farm foreman. Victor knew nothing about the poultry business in 1952 or 1953, but he began to think that he would like to sell a product which he could sponsor. He conducted a poultry business on the farm from April 1952 until March 1, 1959. The trade name of that business was "ViBo Farms" and the registered trademark of his poultry products was "ViBo."

Victor employed a new manager for the ViBo business on two occasions in his efforts to improve production, processing and sales of the chickens, which he called rock cornish game hens. A rock cornish game hen is a superior chicken produced by a cornish rooster and a white rock hen. It matures in from 5 to 6 weeks and has a high ratio of meat to bone. It is not a game bird and need not be a hen, so far as the record discloses.

Victor met Allan Altman in 1953 and thereafter occasionally received advice from him in regard to the ViBo business. Altman was hired as manager at the beginning of 1956.

Sales were being made by mail, directly to hotels and restaurants, and to stores at wholesale.

Victor hired George Campbell in 1956 as his advance press agent and general public relations man. This employment continued at all times material hereto without change.

The following table shows the gross income earned by Victor in each calendar year from entertainment and ViBo losses claimed by him:

Year	Gross Income	ViBo Losses	
1954	$ 628,082.85	$ 62,158.71	
1955	496,655.17	79,486.40	
1956	1,145,981.21	345,879.04	
1957	858,964.65	220,145.95	
1958	802,458.53*	23,133.48	(Jan. & Feb.)
1959	1,036,554.19	.....	
1960	968,403.13	.....	
1961	975,704.40	.....	
1962	772,145.35	.....	
1963	925,205.10	.....	

* The figures shown for 1958 through 1963 include the amounts received by Danica.

Mortimer S. Rosenthal, a lawyer in New York City, advised Victor and acted as his counsel during the tax years. He always considered Victor's tax obligations. He advised Victor to form the Danica corporation and did the legal work in organizing it. He consulted a certified public accountant in regard to possible Federal income tax consequences which might result from the transfer of the ViBo business and Victor's entertainment income to Danica.

Danica was incorporated in February 1958 and on March 1, 1958 it issued its stock to Victor in exchange for the assets of ViBo, subject to its existing liabilities. Victor has always been the President and sole stockholder of Danica. Victor retained title to the land and buildings. The operation of ViBo did not change after the transfer to Danica and the record does not show what, if anything, Danica did in the operation of the ViBo business.

Danica claimed deductions on its returns for all losses from the ViBo poultry business beginning March 1, 1958 and at least through February 28, 1963. The Commissioner in determining the deficiencies against Danica disallowed under section 269, Internal Revenue Code of 1954, deductions for net losses claimed by Danica from the operation of its poultry business to the extent of $259,557.24 for the fiscal year ended February 28, 1959, $144,346.53 for the fiscal year ended February 29, 1960 and $19,473.00 for the fiscal year ended February 28, 1961. The disallowance for each year was the amount of the net loss claimed for that year less $50,000.

Victor, when he appeared professionally, was sometimes able to obtain free advertising for himself and his ViBo business in various sections of local newspapers, in supermarkets, and on radio and television. Occasionally a magazine with national circulation would publish an article relating to his profession and his ViBo poultry business.

Victor and Danica entered into an agreement on March 1, 1958, to continue to February 28, 1963, in which, *inter alia,* Danica employed Victor to help promote and publicize its business activities and to perform artistic and professional services on television, radio and theatrical presentations. Danica agreed to pay Victor $50,000 per year for his artistic and professional services under the contract and for his promotional work for ViBo products. Victor would not have entered into such a contract with an unrelated party. Victor was free to and did perform and appear professionally on his own behalf aside from the contract. A copy of the contract is incorporated herein by this reference.

Victor, to advertise Pontiac automobiles, performed in "The Victor Borge Show" for which he received $200,000 net under a contract dated October 22, 1957.

Danica entered into a contract dated July 24, 1958 to furnish the entertainment portion of television spectaculars starring Victor on behalf of the Pontiac Division of General Motors Corporation for $225,000 net for each performance. Such spectaculars were telecast in November 1958, October 1959, March and October 1960, October 1961 and February 1963. Danica received $226,000 for each of the first two, $225,000 for each of the next two and $250,000 for each of the last two. Victor guaranteed that contract.

The only compensation which Danica paid Victor was $50,000 in 1962 and $50,000 in 1963. It deducted those payments as officer's compensation on its fiscal year returns for 1962 and 1963.

The record does not disclose anything done by Danica to earn or assist in the earning of the entertainment income which it reported.

The only adjustment made in the deficiency notice to the Borges, which is in dispute herein, is the one explained therein as follows:

(a) It has been determined that under the provisions of Sections 61 and 482 of the Code of 1954 income from the phase of the business in the entertainment field of Danica Enterprises, Inc., for the calendar years and in the amounts shown in the table below be ascribed to you and be added to your taxable income:

	1958	1959	1960	1961	1962
Income subject to allocation ...	$75,000	$75,000	$75,000	$75,000	$75,000
Less compensation received and reported	.....	.....	.....	.....	50,000
Net	$75,000	$75,000	$75,000	$75,000	$25,000

Victor's and Danica's poultry operations (pennies omitted) were as follows:

Victor Borge

	1953	1954	1955	1956	1957	1/ 1/58 2/28/58
Sales—net	$ 5,637	$36,952	$118,973	$260,317	$682,560	$121,020
Cost of sales	20,599	69,785	136,129	428,181	567,448	84,091
Gross Profit (loss) .	(14,962)	(32,833)	(17,156)	(167,864)	115,112	36,929
Other deductions—net of other income ..	11,703	29,326	62,330	178,015	335,258	60,062
NET LOSS	($26,665)	($62,159)	($ 79,486)	($345,879)	($220,146)	($ 23,133)

Danica Enterprises, Inc.
Fiscal Years Ended February 28.

	1959	1960	1961	1962	1963
Sales—net	$745,592	$508,953	$111,567	$69,992	$28,046
Cost of sales	547,529	388,895	145,644	69,946	37,563
Gross Profit (loss)	198,063	120,058	(34,077)	46	(9,517)
Sale of equip.	.....	.....	.....	(8,000)	.....
Other deductions—net of other income	507,620	314,404	35,396	37,843	48,069
NET LOSS	($309,557)*	($194,346)	($ 69,473)	($29,797)	($57,586)

* Danica's loss from the operation of ViBo farms for the last ten months of 1958 was in excess of $50,000.

All stipulated facts are incorporated herein by this reference.

OPINION.

MURDOCK, Judge: Victor Borge is a very talented man. He is not only a great pianist but a subtle entertaining comedian too. He came to the United States from Denmark and has made himself famous here. He has also made a great deal of money from personal appearances and performances on T. V. and radio. He bought a farm in Connecticut and that led him to engage in a poultry business, soon limited to what he called rock cornish game hens. He incurred large losses in that business which he deducted from his much larger earnings as an entertainer.

Victor relied upon Rosenthal's advice and guidance in all legal and income tax matters. Rosenthal hoped to find some means of establishing a corporation to be owned by Victor which would make him secure financially aside from his future earnings, or lack of earnings, from professional engagements. The petitioners claim that Danica was created primarily for that purpose and was not created primarily to avoid the effects of section 270 or other tax consequences. *Cf. Frank Spingolo Warehouse Co.* [Dec. 25,067], 37 T. C. 1.

The determination of the Commissioner, limiting Danica's deductions for losses sustained by the ViBo business to $50,000 in each of its tax years, is presumed to be correct and the petitioners have the burden of proving it incorrect. They have failed to sustain that burden. The most persuasive evidence supports the Commissioner's determination.

Victor, as sole proprietor of his poultry business, had sustained losses in that business in excess of $50,000 for the years 1954, 1955, 1956 and 1957. If this had continued through 1958, section 270 might have been applicable. Victor continued to own and operate the business through the first two months of 1958 and sustained a loss of $23,133.48 for that period. Market conditions were unfavorable to ViBo

in 1958. Rosenthal was aware of the impending tax consequences and, in an effort to avoid or lessen them, advised and arranged the incorporation of Danica and the transfer of the ViBo business to it. Danica had no means of meeting a large loss from the operation of the ViBo business which could reasonably be expected and that difficulty was met by providing for a part of Victor's large earnings from entertaining to be diverted for five years through Danica for payment of the ViBo losses.

The evidence does not show that Danica otherwise contributed to, or took any part in, the conduct of the ViBo business or that the conduct of that business changed in any way after February 1958. Nor does the evidence show that Danica aided Victor in his entertainment business. Those who contracted with Danica and paid for Victor's services required him to guarantee personally the contract which was made with Danica. There was no change in the conduct of his entertainment business after February 1958. Its earnings were attributable solely to the services of Victor.

The Commissioner did not err in denying Danica's deductions for ViBo losses in each year in excess of $50,000. Victor acquired control of Danica "after October 4, 1940" and the Commissioner had reason to hold that "the principal purpose for which such acquisition was made" was evasion of Federal income tax within the meaning of section 269(a)(1), I. R. C. 1954. See also sec. 270(a), I. R. C. 1954. *Pauline W. Ach* [Dec. 26,743], T. C. 114, aff'd [66-1 USTC ¶ 9340], 358 F. 2d 342, certiorari denied 37 U. S. 205; *James Realty Co. v. United States* [60-2 USTC ¶ 9600], 280 F. 2d 394. *Cf. L. M. Lockhart* [Dec. 27,280], 43 T. C. 776; *Thomas E. Snyder Sons Co.* [Dec. 24,210], 34 T. C. 400, affd. [61-1 USTC ¶ 9312] 288 F. 2d 36; *Army Times Sales Co.* [Dec. 24,637], 35 T. C. 688.

The contract between Danica and Victor provided that Danica would pay Victor $50,000 annually for his services

under the contract. It paid him nothing in 1958, 1959, 1960 and 1961 but paid him $50,000 in 1962 and in 1963. The Commissioner determined that Victor should have received $75,000 from Danica in each tax year for his services. He allowed Danica to deduct that amount each year and increased Victor's income to correspond. That action seems conservative in view of the fact that Victor earned all of the income which Danica received. *Cf. Helvering v. Horst* [40-2 USTC ¶ 9787], 311 U. S. 122; *Pauline W. Ach, supra; Nat Harrison Associates* [Dec. 26,858], 42 T. C. 601, 622. However, his allocation of the amounts to Victor's taxable income is clearly within section 482, I. R. C. 1954, as "necessary in order to prevent evasion of taxes or clearly to reflect the income of" Danica and Victor, the sole owner of Danica. *Lucas v. Earl* [2 USTC ¶ 496], 281 U. S. 111, 115. See sec. 61, I. R. C. 1954.

Counsel for the petitioners devote a substantial part of their briefs to questions not raised by the pleadings and thus not properly raised or in issue here. Those questions merit no discussion or answer by this court.

Decisions will be entered for the Commissioner.

JUDGMENT OF DECEMBER 17, 1968.

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT.

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the seventeenth day of December, one thousand nine hundred and sixty-eight.

Present: HON. J. JOSEPH SMITH, HON. IRVING R. KAUFMAN, HON. PAUL R. HAYS, *Circuit Judges.*

DANICA ENTERPRISES, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

DANICA ENTERPRISES, INC.,
Respondent.

APPEAL FROM THE TAX COURT OF THE UNITED STATES

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed as modified and that the action be and it hereby is remanded for recomputation of the deficiency in accordance with the opinion of this court.

A. DANIEL FUSARO,
Clerk.

ORDER DENYING REHEARING

31903-4

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT.

VICTOR BORGE AND SANNA BORGE,
Petitioners,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DANICA ENTERPRISES, INC.,
Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
v.
DANICA ENTERPRISES, INC.,
Respondent.

A petition for a rehearing having been filed herein by counsel for the petitioners Victor Borge and Sanna Borge and Danica Enterprises, Inc.,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is denied.

J. JOSEPH SMITH,
IRVING R. KAUFMAN,
PAUL R. HAYS,
U.S.C. JJ.

January 7, 1969

APPENDIX C.

SUPREME COURT OF THE UNITED STATES.

No. , OCTOBER TERM, 1968.

VICTOR BORGE, SANNA BORGE AND DANICA ENTERPRISES, INC.,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE

ORDER EXTENDING TIME TO FILE PETITION FOR WRIT OF CERTIORARI.

UPON CONSIDERATION of the application of counsel for petitioner(s),

IT IS ORDERED that the time for filing a petition for writ of certiorari in the above-entitled cause be, and the same is hereby, extended to and including April 15th, 1969.

/s/ JOHN M. HARLAN,
Associate Justice of the Supreme Court of the United States.

Dated this 7th day of March, 1969.